M&A AND PRIVATE EQUITY REPORT 2008: MAKING SENSE OF MARKETS IN TURMOIL

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The Iberian deal market has seen a definite slow down in the scale of transactions, say lawyers, nonetheless opportunities remain for those that can adapt to the new environment.

Un análisis de las últimas transacciones demuestra que a pesar de los titulares en la prensa sobre la crisis económica, de liquidez y el creciente número de empresas insolventes, el mercado de las transacciones permanece vivo, aunque hay una serie de abogados de la Península Ibérica que insinuan un giro decreciente en su actividad.

Sin embargo, este optimismo no corresponde con las predicciones de reducción en operaciones de Fusiones y Adquisiciones y Capital Riesgo. Incluso añadir que muchas firmas consideran que todavía están disfrutando de los últimos coletazos del boom acaecido en los últimos años y que la crisis crediticia está aún por llegar.

An analysis of the deal tables will demonstrate that despite the headlines of an economic slowdown, a liquidity crisis and a rising number of corporate insolvencies, the transactional markets nonetheless remain alive, with some Iberian lawyers actually reporting an upturn in transactional activity.

However any such optimism does not correspond entirely with current predictions of an M&A and private equity (PE) slowdown in the year ahead. Indeed, some firms believe that they are currently only enjoying the last remains of the deal-making boom of the last few years, and that the full effects of the credit crunch have yet to be felt.

Banks' ongoing liquidity concerns have clearly begun to limit the ability of many to finance acquisitions, and there is no longer any appetite among the banks for highly-leveraged deals. The resulting issues facing many private equity houses were demonstrated dramatically in March by the collapse of the Amsterdamlisted €22bn Carlyle Capital Corporation mortgage-backed securities fund.

Additionally, despite the potential takeover bid for Spain's second-largest energy company, Iberdrola – which has already launched a preemptive defensive legal strike against France's EdF – and the volume of work such a deal would bring for many of Spain's leading firms, the consensus remains that deal volumes for the year ahead will likely be down on last year, and that there with be minimal practice growth.

Lending terms

Nonetheless lawyers suggest that there are clearly opportunities for buyers with adequate capital. Sectors with stable values, such as energy and utilities, remain attractive while there is emerging deal activity surrounding cash-poor but asset-rich companies – notably in the weakening real estate sector.

But a significant issue clearly is gaining access to credit on viable terms, María José Menéndez at Ashurst and Manuel Castelo Branco at Gonçalves Pereira Castelo Branco & Associados are among those that note the virtual reversal in bargaining power between lenders and borrowers over the past year.

"Opposite to what occurred during the first semester of 2007, with banks competing for transaction financing, since August 2007 we have seen the banks become much more reluctant to change or improve the conditions initially offered. In this regard, the possibilities to negotiate have become almost non-existent," agrees Francisco Aldavero at Madrid's Araoz & Rueda.

The general scenario is a return to traditional financing models, says Christian Hoedl at Uría Menénedez. "Covenant-lite and similar approaches have disappeared from the market, while MAC (Material Adverse Change) clauses are once again being imposed."

With such a strict approach to finance being adopted investors can quickly find themselves running out of alternatives, suggests Jose Antonio Sánchez-Dafos, Head of Corporate at DLA Piper in Madrid. "Therefore they will accept virtually any terms. In addition, only investors with strong track records are currently getting past credit committees."

The situation is similar in Portugal, say lawyers there, and even when finance terms are agreed the difficulties do not end there. Clients have to ensure that they remain able to manage the debt. "It is a fact that the increased spreads make it much more difficult to leverage any acquisition. I think however that the greatest difficulty is uncertainty for the future and the fear that a credit facility may turn out to be a nightmare if shortage of liquidity leads to further increases in spreads," says Miguel Teixeira de Abreu of Abreu Advogados in Lisbon.

Nonetheless some believe that even within the current conditions a lending market does exist. “Although the ability of the banks and lenders to dictate credit terms remains high, borrowers nonetheless do have increased bargaining power due to the still high competition among lenders,” suggests Rodrigo Almeida Dias, partner at F. Castelo Branco & Associados.

Buying ambitions

Such an environment for finance is inevitably having an effect on buyers’ ambitions, even if some sellers do not yet realise it, suggests Sánchez-Dafos at DLA Piper. “The current M&Aequation does not work. Sellers still feel that they can get high multiples, but buyers (especially private equity houses) do not want to and often cannot pay such high prices.”

But despite the credit issues affecting private equity firms, and the subsequent moratorium on highly-leveraged deals, lawyers nonetheless report that they are seeing little immediate change in investment plans among their private equity clients locally. Deals are merely being put on hold in the hope that the markets will recover.

“We are still seeing private equity houses actively looking for deal opportunities, and to consolidate their portfolios,” says Fernando Torrente at Cuatrecasas. “Some big international companies may also take advantage of their size and soundness in a less optimistic economic scenario and benefit from the opportunities to acquire good companies that may be suffering in the current circumstances.”

Among the sectors in which there is a prediction of an upturn in deal activity are construction and real estate – where the cashflow difficulties being experienced by many present clear opportunities for those willing to negotiate. “There will be an emerging area of investment in respect of distressed assets and the market will start to see new PE entrants focused on this sector,” says one Madrid-based partner at an international firm.

The relatively limited scale of investment opportunities available in Portugal has meant that lawyers there report little significant change also in the investment emphasis of private equity clients. “Portugal is still very conservative regarding the deal focus of private equity houses, and the most common areas of activity remain start-ups and expansions,” says Almeida Dias at F. Castelo Branco & Associados.

One result is that Portuguese firms are seeing less of a swing in transactional activity than their Spanish peers, suggests Jorge Bleck, Head of Corporate at Linklaters in Lisbon. “Two years ago Portugal saw two multi-billion euro deals – Sonaecom’s takeover attempt for Portugal Telecom, and Millennium BCP’s bid for Banco BPI – but these were atypical of a market in which the majority of deals continue to be valued under €500m.”

The €11.9bn value of the Sonae bid alone was equal to the value of all other M&A deals in Portugal in 2006.

Trade buyers

A drop in prices, and competition for targets, means however that the current market scenario is benefiting trade and industrial buyers, say lawyers across Spain and Portugal.

“Up until last summer trade buyers were regularly being priced out of attractive strategic deals because of the very high multiples being applied to company valuations – which the private equity houses were willing to pay,” says Carlos Pazos, managing partner of SJ Berwin in Madrid.

“Trade buyers with capital reserves clearly now have the opportunity to take advantage of the decrease in asset prices and increase their strategic investment activity.”

Fernando Campos Ferreira, Head of Corporate at PLMJ in Lisbon agrees: “Companies are definitely now better able to compete, and will continue to do so for as long as private equity houses do not wake from their liquidity crisis induced beauty sleep.”

Alongside an increase in corporate buyers, the other significant feature of the current market is a decrease in deal size, say lawyers.

“The mega deals have disappeared for the time being and we have seen an increase of transactions in the middle market segment,” says Graciela Llaneza at Lovells in Madrid.

But such a development does not mean that there is less demand for deals. “In general, private equity investors that are willing to do deals with a lower ratio of leverage are in a position to do more deals,” says Fernando Vives at Garrigues.

Although target values may have decreased from the market highs, and company buyers and private equity players may still compete for the same targets, some suggest that sellers are still best placed to dictate the terms of deals.

“Our recent experience is that the new situation is characterised by transactions of lower amounts and by a rationalisation of prices. The effects of the new situation are not as important for industrial players as they are for private equity funds and therefore, industrial players are increasing their investment activity,” says Iván Delgado at Perez-Llorca “In addition the number of auction sales is decreasing and the shareholders of the target companies have the opportunity to choose funds offering better conditions and higher prices.”

In any event lawyers report that certain sectors continue to see strong deal activity, and where both domestic and international buyers looking to make strategic acquisitions and better position themselves ahead of emerging opportunities.

“We are seeing more investment opportunities in energy and utilities – notably with the privatisation in Portugal of the water suppliers – and infrastructure sectors (relating to Lisbon’s proposed new airport) which counterbalances the decline in, for example, the real estate market,” says João Nuno Barrocas at Barrocas Sarmento Neves in Lisbon.

Consequently foreign companies, particularly Spanish companies, as well as private equity and hedge funds remain active in Portugal, agrees Almeida Dias at F. Castelo Branco & Associados. “Energy and healthcare remain fashionable areas for investment, while transport might also be a developing area with the increasing probability of the privatisation of TAP, the major Portuguese airline.”

Companies and assets with more secure demand and values will continue to be attractive, whatever the prevailing market conditions, suggests Aldavero at Araoz & Rueda. "Energy, technology and healthcare continue to be sectors in which private equity funds continue to show great interest.”

Expansion

Lawyers are also seeing clients take advantage of the prevailing market conditions to seize opportunities beyond their own borders, particularly as domestic competition increases among the largest players.

“The interest of local companies for international acquisitions has also been maintained over recent years, and in many cases this is now the sole means of continued growth,” says Francisco Brito e Abreu at Uría Menéndez in Lisbon.

João Vieira de Almeida at Vieira de Almeida agrees, but notes: “There are Portuguese companies looking for opportunities to invest abroad but they are still very few and predominantly limited to companies from certain industries, for example, energy, industry and infrastructures."

A similar scenario is also apparent in Spain. "Large Spanish companies need to explore other markets – ours may be too small for their expectations and opportunities may be too costly," suggests Sánchez-Dafos at DLA Piper.

Spanish companies with a sound financial base are clearly very well positioned, agrees Juan Francisco Falcon at Uría Menénedez. They may also have currency fluctuations on their side. "The international expansion strategies of domestic clients, especially to those countries with weakened currencies such as the US, is clearly being facilitated by the strengthening Euro," says Marta Gil de Biedma at Ventura Garcés & López-Ibor.

Holistic approach

But while such developments clearly presents opportunities, they play to the strength of law firms with the strongest international relationships and networks, say some.

"The Spanish market is changing and domestic companies are growing and expanding their businesses abroad, for example Criteria, Ferrovial, Iberdrola, Telefónica and Azora. We would expect to help in their international expansion," says Armando Albarrán, corporate partner at Freshfields Bruckhaus Deringer in Madrid.

Legislating change

A potentially significant development for deal-making in Spain, given the current inability of many to finance complete takeovers, was the implementation last year of a new Company Takeover Code – which, say lawyers, presents parties with new opportunities in terms of deal structuring.

"The new Spanish regulation on takeover bids provides potential bidders with interesting new resources to gain control of listed companies and opens the door to different strategies in the context of takeover bids," says Iván Delgado at Perez- Llorca.

While there have been no comparable changes in Portugal – the Portuguese Securities Code already includes most of the provisions of the EU Takeover Directive – recent legislative changes may well have an impact, suggests Nuno Galvão Teles, at Lisbon's Morais Leitão Galvão Teles Soares da Silva & Associados: "The recent changes to the rules on competing offers will though likely have an impact on the number of takeover offers," he says.

In addition, personnel changes within the Portuguese Competition Authority (Autoridade da Concorrência – AdC) may also have an effect, and which continues to demonstrate a robust approach to merger control issues.

"The Portuguese regulators have faced challenges over the last few years but while their work rate may have been questioned their independence never has been," says Pedro Cardigos at ABBC.

As well as the need to demonstrate to clients that local law firms are able to offer value to clients as they expand abroad an issue also – particularly for Spanish law firms – is how to manage the apparent emerging move away from transactional work, and to ensure that the large M&A teams built up over recent years remain active.

"Some flexibility to re-allocate talent will always be good, for instance, from finance to insolvency, as there will be less big deals and it is important to remain active in the midmarket," says Torrente at Cuatrecasas.

Firms have to be able to capitalise on the changing focus of clients and the deal markets if they are to continue to prosper, say many. "Making sure that lawyers are active is and always will be the name of the game. Full service firms have to build practices perceived as being capable of providing “niche” expertise,” suggests Fernando Campos Ferreira at PLMJ.

Essential also is the ability of lawyers to operate across business and practice areas, say others. “Even if the deal markets are not slow, we consider that lawyers should be active in various sectors as it widens their experience,” says Nuno Galvão Teles, Head of Corporate at Lisbon’s Morais Leitão Galvão Teles Soares da Silva & Associados.

But as firms increasingly target the same deal space (and deals of lower value), some suggest that price will increasingly become a differentiator. “As the practise of law becomes ever more competitive, the advantage of law firms lays more and more with the ability to offer new solutions and greater in-depth technical knowledge,” suggests Teixeira de Abreu of Abreu Advogados.

“Although growing competition amongst law firms is a fact, we firmly believe that the most knowledgeable firms will succeed. There is obvious pressure on fees but Portugal is still well below other European countries in that respect. We see no reason why such pressure should hit us before it hits our Spanish colleagues, for example.”

Firms in Spain have already been feeling the pressure. “So far, we have not perceived any change: fee pressure continues to be very high,” says the managing partner of a mid-size Spanish firm. Nonetheless others believe that a select few will be able to place continued emphasis on their reputation and / or niche expertise. “It may be too soon to say, but for the moment we are not feeling either fee pressure or competition from other law firms,” says a partner at a leading Madrid firm.

Uncertain times

Clearly many law firms are trying to make sense of the current market turmoil, and to assess the full potential impact on their clients and ultimately their own practice groups.

“There are opportunities but it is a question of market confidence, ultimately the economy is on standby” says Luís Miguel Cortes Martins at Serra Lopes Cortes Martins e Associados in Lisbon.

A similar sentiment is shared in Spain, “A certain restraint may detected within the M&A market, partly as a result of the recently held elections and the need to wait for a new government and partly as a result of the adjustment process that the market is undergoing as regards the value of assets as well as available liquidity.”

Nonetheless, few believe that looking ahead, the Iberian situation will be without its difficulties. “Notwithstanding wishful comments to the contrary, further waves are likely to be felt although there will probably not be a tsunami,” adds Campos Ferreira at PLMJ.

The leading Spanish and Portuguese banks may have had limited exposure to the root causes of the credit crunch, but the global nature of the money markets – and the liquidity issues that prevail – means that Iberian companies are no better placed than those elsewhere when it comes to raising finance for deals.

“In general, we could say that the current situation is affecting sellers and purchasers equally, both are limited by the multiples that the banks are willing to finance as well as by the harder conditions they are imposing,” observes Aldavero at Araoz & Rueda.

Clearly opportunities do exist for either trade buyers or private equity houses with access to funds, which are now in theory better positioned to take advantage of lower values, to make strategic purchases or to acquire the assets of troubled companies.

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“It depends of course on who you are representing but for industrial companies this is a year of opportunities,” adds Luis Riesgo, managing partner of Jones Day in Madrid, which represents more than half of the Fortune 500 companies.

“After a steady increase in private equity deals over the past few years, we believe that the situation will stabilise, if not invert this year. However opportunities remain for those able to adapt to the new environment,” says Brito e Abreu at Uría Menéndez in Lisbon.

There is however a clear preference among investors towards those funds truly able to create value and to demonstrate specialisation, say Julio Veloso and Javier Morera at Rodés & Sala.

“Within Spain, distressed company funds are very much in fashion, while dedicated real estate asset funds are on the horizon.” “Deals are still happening but are taking longer, and some have stalled. What was the exception is increasingly the general rule,” says Alejandro Ortiz at Linklaters in Madrid.

While some senior lawyers may point, off the record, to the potential impact on practices of some very large deals this year – as may be seen in Spain’s energy sector or the banking sector in Portugal – few are willing to plan their own practice growth strategies around them. Some are even concerned that it may be those law firms most used to operating at the top of the market that may suffer the most as big-ticket deals become less frequent.

If so, a continuing analysis of the deal tables over the coming year – and firms’ presence in them – may offer a good measure of the relative health of many in the Iberian legal market.